

IT 95-64

Tax Type: INCOME TAX

Issue: Unreported/Underreported Income (Fraud Application)
Innocent Spouse Rule Application

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
SPRINGFIELD, ILLINOIS

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THE DEPARTMENT OF REVENUE      ) Docket #
OF THE STATE OF ILLINOIS      ) SS #
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                               ) TYE12/31/80 - 12/31/86 12/31/87
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v.                             )
                               )
XXXXXX                        ) James Pieczonka
                               ) Administrative Law Judge
Taxpayer                      )
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RECOMMENDATION FOR DISPOSITION

APPEARANCES: XXXXX, for XXXXX; Colin Relphorde, Special Assistant Attorney General, for the Department of Revenue.

SYNOPSIS: This matter came to be heard as a result of Notices of Deficiency being issued by the Illinois Department of Revenue on January 26, 1990, proposing assessments and penalties against the persons of XXXXX, XXXXX and XXXXX (deceased) for failure to report income for the periods in question and to pay taxes due thereon as required by applicable sections of the Illinois Income Tax Act. Following timely protests being filed on the part of XXXXX and XXXXX, a hearing was held for the purpose of presenting evidence both for and against the issues of liability raised. On the basis of the evidence of record, it is recommended that the matter be resolved in favor of the Department in part and in favor of the taxpayers in part.

ISSUES:

1. Whether taxpayer XXXXX omitted in excess of 25% of the base income reported on her joint Illinois income tax returns for the years ended 12/31/80 through 12/31/86, and on her single return for the year ended 12/31/87.

2. Whether XXXXX is liable for additions to tax under IITA Section 1002(b), 35 ILCS 5/1002(b), viz., a civil fraud penalty at a rate of 50-75% for the years in question.

3. Whether taxpayer, XXXXX, is relieved from liability for the deficiencies and additions to tax pursuant to the "Innocent Spouse" defense of IRC Section 6013(e) for the years 1980 through 1986, inclusive.

4. Whether taxpayer XXXXX, is relieved from liability for the deficiency and additions to tax pursuant to the "Innocent Spouse" doctrine of IITA Section 502(c)(4), 35 ILCS 5/502(c)(4) for the 1987 tax year.

5. Whether taxpayer XXXXX is liable for a Section 1002(b) civil fraud penalty at 50-75% for the period between 1980 and 1986.

6. Whether taxpayers XXXXX and XXXXX are liable for a Section 1002(b) civil fraud penalty at 50-75% for the 1987 tax year.

FINDINGS OF FACT:

1. XXXXX and his first wife, XXXXX, filed joint federal and Illinois income tax returns for the years ended 12/31/80 through 12/31/86. (Dept. Ex. #20)

2. On May 20, 1987, XXXXX divorced XXXXX and married XXXXX on October 17, 1987. XXXXX filed an IL-1040 return as a "single" and XXXXX and XXXXX file a "joint" IL-1040 return for the year ended 12/31/87. (Dept. Ex. #20)

3. XXXXX and XXXXX were signatories on a joint checking account at the XXXXX Bank of XXXXX. Said account was closed in June, 1987, subsequent to the divorce of XXXXX and XXXXX, dated May 20, 1987. (Transcript (Tr.) 73)

4. On August 5, 1988, a felony arrest warrant was obtained for XXXXX by the XXXXX Police Department charging her with theft by embezzlement. (Dept. Ex. #23) XXXXX later plead guilty to said charges. (Dept. Ex. #20) Subsequently, XXXXX died on August 13, 1989. (Tr. 196)

5. XXXXX was a part-time bookkeeper/secretary and worked for XXXXX since 1973. She was paid W-2 wages of \$5.50 per hour on the basis of 20 hours per week. Later she also worked for XXXXX and prepared income tax returns during the tax season. (Tr. 43; Dept. Ex. #23)

6. XXXXX worked for the Illinois Department of Revenue as a collections supervisor since 1975. (Tr. 227) Also, he worked part-time as a special process server from 1979 until 1985. (Tr. 227)

7. On January 26, 1990, the Illinois Department of Revenue issued Notices of Deficiency to XXXXX and XXXXX for the years ended 12/31/80 through 12/31/86; to XXXXX and XXXXX for the year ended 12/31/87; and to XXXXX for the year ended 12/31/87, based upon the unreported income realized from the embezzlements by XXXXX. (Dept. Ex. #s 15, 16, 17)

8. On March 12, 1990, XXXXX and XXXXX timely filed a protest to the Notices of Deficiency. (Dept. Ex. #18) XXXXX's Estate, however, did not file a protest on her behalf.

9. A hearing was held after a number of continuances (Dept. Ex. #s 1-14) on April 23, 1992 before Administrative Law Judge James P. Pieczonka. Present for the Department was Special Assistant Attorney General, Colin B. Relphorde and witnesses, Gregory Dickinson, Criminal Investigator, and Lance Evans, Revenue Audit Manager. Present for Taxpayers, were, XXXXX, their attorney of record (Dept. Ex. #18) and witnesses, XXXXX, XXXXX, XXXXX and XXXXX. The Department introduced Department's Exhibits 1-19 as part of the prima facie case. Taxpayer objected to Exhibits 15 and 16 as to the computations. The objections were noted for the record and Department's Exhibits 1-19 were admitted.

10. Gregory J. Dickinson, Illinois Department of Revenue Criminal Investigator, testified to the following:

- a) The investigation of the Taxpayers began in March of 1989 regarding the years ended 12/31/84 through 12/31/87.
- b) The investigation was initiated due to the receipt of a

police report from the XXXXX Police Department which stated that XXXXX had been charged with the criminal offense of embezzlement from her employer XXXXX. (Tr. 25)

- c) The investigation showed that XXXXX had written XXXXX checks out of series to herself without authority and deposited a majority of them into a joint checking account with XXXXX as joint signatory, at XXXXX Bank of XXXXX. (Tr. 27; 48)
- d) Investigator Dickinson obtained from microfilm at XXXXX Bank of XXXXX, deposit slips and all the checks related thereto of the XXXXX checks payable to XXXXX. Schedules were prepared which showed embezzled funds per year as follows:

1984	\$ 33,774.09
1985	\$ 41,871.96
1986	\$ 47,131.28
1987	\$ 30,872.68
Total	\$153,650.01

- e) Line 1, AGI income on XXXXX and XXXXX's IL-1040 filed returns was reported as follows:

1984	\$ 24,753.00	
1985	\$ 27,162.02	
1986	\$ 29,152.12	
1987	\$ 32,341.11	XXXXX & XXXXX
1987	\$ 4,691.86	XXXXX

- f) The W-2 income of XXXXX was reported as follows:

1984	\$ 17,390.20	
1985	\$ 19,163.46	
1986	\$ 19,809.04	
1987	\$ 7,628.96	(Prior to divorce)

- g) The W-2 income of XXXXX was reported as follows:

	XXXXX	XXXXX
1984	\$ 1,260.70	\$ 1,246.20
1985	\$ 1,038.00	\$ 2,396.70
1986	\$ 1,056.00	\$ 1,766.10
1987	\$ 1,148.13	\$ 2,064.90

- h) The XXXXX checks deposited in to the XXXXX joint checking account were as follows:

1984	\$ 25,151.52	
1985	\$ 33,589.91	
1986	\$ 33,019.20	
1987	\$ 10,428.00	(Prior to divorce)
1987	\$ 10,383.35	(After divorce)

- i) Cash amounts deposited into XXXXX joint checking account were:

1984	\$	5,112.21	
1985	\$	5,405.00	
1986	\$	9,752.93	
1987	\$	3,984.12	(Prior to divorce)
1987	\$	2,145.00	(After divorce)

- j) Other amounts deposited into XXXXX joint checking account were:

1984	\$	2,650.21	
1985	\$	18,199.45	(Inheritance)
1986	\$	14,541.30	(Bank card adv.)
1987	\$	6,232.50	(Cash Advance)

- k) Unreported income of XXXXX was determined as follows: (XXXXX checks minus W-2 wages)

1984	\$	32,513.39	
1985	\$	40,833.96	
1986	\$	46,075.28	
1987	\$	21,035.86	
1987	\$	8,688.68	(XXXXX prior 5/20/87)

(Tr. 35-72; Dept. Ex. #s 23, 15, 16)

- l) Investigator Dickinson only examined checks deposited into the XXXXX joint checking account and did not examine checks drawn on the account. (Tr. 62) The joint checking account of XXXXX and XXXXX, subsequent to XXXXX's divorce, was not examined. (Tr. 65)

- m) The major assets of XXXXX and XXXXX were known to be as follows:

XXXXX	1985 Oldsmobile (financed)
XXXXX	1969 used Ford station wagon
Rental Home	(Leased)

(Tr. 280; 243; 241)

- n) Investigator Dickinson stated that he issued four requests to the IRS for exchange of tax information regarding the XXXXX returns for 1984-87. (Tr. 82) However, he did not recall if any information was exchanged or the content of the conversation with the IRS. (Tr. 85)

11. Lance Evans, Department of Revenue Field Audit Manager, testified as follows:

- a) In March of 1989, he conducted a confidential civil income tax audit of XXXXX, XXXXX and XXXXX (Tr. 93) based upon the embezzled funds by XXXXX for the years 1980 through 1987. Information showed that XXXXX had been embezzling for nine years. (Tr. 110)
- b) He did not interview XXXXX or XXXXX but examined an

affidavit of XXXXX which admitted that she embezzled approximately \$250,000 from XXXXX during 1980-87. (Tr. 98)

c) He reviewed the XXXXX Bank of XXXXX account deposits and checks from the XXXXX Co., and subtracted XXXXX's W-2 income to determine the embezzled funds amount. Some amounts were deposited into a joint account with XXXXX and some checks were cashed at Dominick's stores. (Tr. 104)

d) XXXXX checks written to XXXXX were as follows:

1984	\$ 33,747.00	
1985	\$ 41,872.00	
1986	\$ 47,136.00	
1987	\$ 30,873.00	
Total	\$153,628.00	(Tr. 105)

e) XXXXX's W-2 income of \$4,481.00 was deducted from the XXXXX check amounts to arrive at unreported income of \$149,147.00 during the years from 1984 through 1987, inclusive. (Tr. 105)

f) To determine unreported income for the years between 1980 and 1983, since information was unavailable, Mr. Evans computed with the best information available, a 48 month average by dividing \$149.147 by 48 months to arrive at a monthly average of \$3,107.23. The yearly average of \$37,284.00 was then calculated (Tr. 106-112) and added to the reported income for the years 1980 through 1983. (Tr. 107-112)

g) The civil audit also proposed civil fraud penalties pursuant to Section 1002(b) of the IITA, due to the underreporting of income in excess of 1.5 times the reported adjusted gross income. (Tr. 113) The total embezzled funds were determined to be \$299,432. (Dept. Ex. #20; Tr. 117)

h) Mr. Evans reviewed the joint Federal and IL-1040 returns of XXXXX and XXXXX, XXXXX and XXXXX and the separate returns for XXXXX for 1987, payroll and W-2 information, 1099 forms and the bank deposits and checks to arrive at the proposed deficiencies. (Tr. 119; Dept. Ex. #s 15, 16, 17, 20)

i) Mr. Evans did not review the checks out of the XXXXX checking account except for one month. However, he determined that the funds were a mutual benefit to both parties on the account. Expenses related to charge cards, dinners, utilities, car payments and rent were paid from the checking account. (Tr. 127, 188; Dept. Ex. #20)

12. Mr. XXXXX was called to testify as a witness on behalf of XXXXX and XXXXX. (Tr. 133) Mr. XXXXX is a professional accountant with a

Bachelor's degree in accounting and a Master's degree in taxation. He is an enrolled agent with the IRS and has been a Professor of Accountancy at Lewis University for the past 27 years.

13. Mr. XXXXX was a social friend of the XXXXX and has prepared their federal and Illinois returns for the past ten years (Tr. 135)

14. On a social basis they went to dinner occasionally and Mr. XXXXX paid for dinner more often than did the XXXXX. The XXXXX lived in a rented house on XXXXX Street in XXXXX. (Tr. 137) XXXXX owned an Oldsmobile for a number of years subject to financing. (Tr. 135)

15. Mr. XXXXX classified the XXXXX lifestyle as modest and not out of place with their income. (Tr. 140) They did not have expensive jewelry or clothes or take lavish vacations. (Tr. 145, 150) Mr. XXXXX stated that from his observations of the XXXXX lifestyle, he did not believe large sums of money were unreported. From the information given to him in preparation of the XXXXX' tax returns, he believed they were accurate as filed. (Tr. 146, 160-169) However, he did not review any bank statements or tax records in preparation of the returns. (Tr. 164) XXXXX prepared schedules and provided information for compilation into the final return. (Tr. 148, 154) Mr. XXXXX was familiar with the salaried income of XXXXX and XXXXX and specifically asked both of them if all income was reported. (Tr. 149, 169). He generally reviewed the final returns with XXXXX or both parties prior to their signature. (Tr. 156-159)

16. XXXXX testified that she was a social friend of XXXXX and XXXXX since 1982. Later, subsequent to XXXXX's divorce from XXXXX in May of 1987, XXXXX married XXXXX on October 17, 1987. (Tr. 192, 194) Her first knowledge of the subject tax deficiency was receipt in the mail of the instant Notice of Deficiency dated January 26, 1990. (Tr. 192; Dept. Ex. #16)

17. Additionally, XXXXX stated that XXXXX prepared the joint tax

return in 1987 for himself and XXXXX. (Tr. 195) All income was reported from both filers, i.e, XXXXX's salary and alimony payments to XXXXX from a prior marriage. (Tr. 196)

18. During the five years prior to marrying XXXXX, XXXXX did not receive any income from XXXXX or XXXXX and she did not notice any change in his life style. (Tr. 197) Also, she was not familiar with his expenses or finances prior to her marriage to him. (Tr. 198)

19. XXXXX was called as a witness on behalf of the taxpayers. XXXXX retired in 1988 from the Illinois Department of Revenue as a conferee after service with the Department since 1962. Prior to his employment with the Department, XXXXX was an IRS Special Agent in the Tax Fraud Division and later left for private practice. (Tr. 199-201)

20. During his years as Conferee, XXXXX believed that Illinois followed the IRC "Innocent Spouse Rule" by incorporation under Sections 102 and 104 construction of the Illinois Act. A major factor in the determination of the applicability of the Innocent Spouse Rule depended upon the examination of where the unreported income was spent. (Tr. 204)

21. XXXXX was not familiar with the lifestyle of XXXXX, however, he agreed that lack of property ownership, expensive cars, jewelry and moderate spending are factors of an innocent spouse. According to XXXXX, the burden of proof as to fraud is on the Department and an average to project unreported income for unaudited years (80-83) is not proper in the case of fraud penalties (Tr. 209) when records were obtainable by subpoena.

22. XXXXX stated that if an Illinois investigation was conducted on a return, and passed the determination on to the IRS, failure of the IRS to proceed would not preclude Illinois from proceeding on the State level to adjust or increase income. (Tr. 213). The federal adjusted gross income is the starting point for Illinois purposes and not a final determination of actual income. (Tr. 220) However, it may prejudice the State's case.

(Tr. 213).

23. XXXXX also testified, that in the event the innocent spouse defense is invoked by a taxpayer, the auditor should further investigate as to actual knowledge of additional income and acquisitions in excess of normally expected items in view of the couples employment income. (Tr. 215-219) Also, admitted embezzlement by the spouse that committed it is sufficient to establish fraud as to that spouse. (Tr. 221).

24. XXXXX testified on his own behalf to the following facts:

- a. He married XXXXX in April of 1973 and had two children. The family finances were managed by both spouse prior to the birth of their first child in 1975.
- b. XXXXX joined the Illinois Department of Revenue in the spring of 1975. XXXXX was a field employee who basically worked out of his home. (Tr. 227).
- c. In January 1989, XXXXX was assigned temporarily to an office in XXXXX, Illinois where he lived in a hotel during the week for 4 months. (Tr. 227). Also, XXXXX worked nights and weekends as a Civil Process Server since 1979.
- d. XXXXX returned to employment in 1977 for XXXXX as their bookkeeper. (Tr. 228) XXXXX set up a P. O. Box for all the XXXXX' mail across the street from her employer. (Tr. 229)
- e. From 1977 to the date of divorce in 1987, XXXXX's paychecks, all bills, and bank statements were mailed to the P.O. Box and picked up by XXXXX. (Tr. 229-230) XXXXX paid all the bills between 1980 and May of 1987. The record, however, reflected that the three bank statements from the checking account for the months of September/October of 1986, February/March of 1987 and March/April of 1987 disclosed that the checking account statements were addressed to the XXXXX' residence of XXXXX St., XXXXX, IL 60436. (Txp. Group Ex. #8).
- f. XXXXX had minimal involvement in family finances and never reviewed family financial statements (Tr. 230) and did not prepare their tax returns.
- g. In 1983, XXXXX became a collection supervisor and worked 8:00 a.m. to 5:00 p.m. at the office in XXXXX. In 1984, XXXXX was assigned to a special project in XXXXX which required his presence in XXXXX one or two weeks per month for approximately 2 years (Tr. 232), until the fall of 1986. The marital relationship has deteriorated over the years and a divorce was entered

in May of 1987. (Tr. 233).

- h. XXXXX and XXXXX had one checking account and one savings account during their marriage. XXXXX carried the check book and gave XXXXX one or two blank checks per months. XXXXX always reconciled the checkbook. (Tr. 233)
- i. In 1985, XXXXX quit his process server job; the Department's salary was his only income and he received no inheritances.
- j. XXXXX received an inheritance from her aunt in the form of a joint-tenancy savings account in the amount of approximately \$3-6,000.00 in 1983. Later, in 1985, XXXXX received about \$15,000.00 in proceeds from the sale of income property which she also inherited in 1983 from her aunt. (Tr. 236).
- k. A divorce settlement agreement was entered into whereby XXXXX agreed to pay child support, all marital debts (\$5,000.00) and maintain health insurance for XXXXX and the children (Tr. 237), and pay for parochial tuition through the 8th grade for both children.
- l. XXXXX initially learned of XXXXX's embezzlement conduct in August of 1988 when the XXXXX Newspaper published an article reporting that XXXXX had been arrested for embezzlement. (Tr. 238).
- m. At the time of XXXXX's divorce from XXXXX, she was still working for XXXXX. XXXXX retained custody of all the bank records and she refused to turn them over to XXXXX. (Tr. 239-240)
- n. XXXXX denied any knowledge of unreported income or XXXXX's embezzlement from XXXXX (Tr. 241) and to date found her conduct hard to believe. (Tr. 244) XXXXX believed every penny they earned was reported. (Tr. 307).
- o. XXXXX and XXXXX did not take any vacations in excess of \$1,000.00 except in one year to Ireland after XXXXX received her inheritance. They owned no expensive jewelry, stocks or bonds. Also, XXXXX bought clothes for XXXXX on occasion. (Tr. 241-244).
- p. Taxpayer Exhibit 9 was introduced through the testimony of XXXXX. The exhibit consisted of copies of checks from their joint-checking account for the month of April 1987 which, according to XXXXX were the only checks XXXXX obtained from XXXXX's house after her death (Tr. 249); and checks from February-March of 1984, May-June of 1985 and September-October of 1987, which were randomly selected by month by the bank pursuant to subpoena for XXXXX's criminal trial. (Tr. 250-254) A check register for the period of 1/11/87 through 4/87 was also recovered, however, it did not

have a running balance. The checks showed that XXXXX was the maker of virtually all of the checks which numbered approximately ninety per month. The deposits varied at approximately 15 per month. The checks were written in variable amounts in range from a few dollars to large sums which were mostly in payment of credit card bills and restaurant tabs. (Txp. Ex. #9; Tr. 252)

- q. XXXXX stated that he had little or no knowledge or control of the family finances during the period in question. He wrote very few checks (one or two per month) from the checking account. (Tr. 307) He was given a few blank checks by XXXXX which he kept at the office to pay for emergency expenses such as car repairs or tobacco (\$20.00 per month). (Tr. 272) XXXXX would also give him cash for spending money in the amount of \$30-40 per week. (Tr. 304).
- r. Simple discussions were had over dinner or in the car as to family finances or expenses. XXXXX made the monthly car payments and had originally set up the financing. (Tr. 280). XXXXX was not sure of his gross salary from the Department because his checks were mailed directly to the Post Office Box which XXXXX had a key to but never accessed. (Tr. 273) XXXXX would endorse his checks and deposit them into the joint-checking account. (Tr. 282) Also, XXXXX was not aware of XXXXX's salary at XXXXX. (Tr. 289) XXXXX's only involvement in the preparation of their tax returns prior to June of 1987 was to submit W-2 forms and information for his schedule "C" income and expenses to XXXXX so that she could prepare the schedule. (Tr. 266, 299) XXXXX did not review the returns with his preparer, Mr. XXXXX, he would simply check for the refund or payment amount and sign the return; he did not examine the return or check the adjusted gross income reported. (Tr. 270, 272) Also, XXXXX seldom made deposits or withdrawals from the bank, however, if he did no balance was shown on his receipt. (Tr. 297).
- s. XXXXX also stated that he dined out approximately once per week and ran a monthly tab at a few restaurants of friends or relatives of his wife. (Tr. 287) XXXXX had an American Express Gold card that was pre-approved, he never completed an application for credit. Additionally, they had 4 or 5 other credit cards and a line of credit that XXXXX utilized during the marriage by forging XXXXX's signature. (Tr. 292) During the marriage, XXXXX did not review credit card bills and did not write checks in payment of the credit card bills. (Tr. 302)
- t. Furthermore, XXXXX stated he was represented by an attorney regarding his divorce and settlement agreement whereby he agreed to be liable for all the marital debts in the amount of approximately \$5,000.00 and to pay child support and school tuition and insurance for the children and XXXXX. However, no formal discovery

or inquiry was made into XXXXX's assets or the bank accounts, nor were the debts verified prior to their assumption. (Tr. 275, 300)

- u. Finally, XXXXX stated that he had no idea of the checking account balance during the marriage. However, at the time it was closed in May of 1987 it had a zero balance. XXXXX did not know where the unreported income had been spent or disbursed. (Tr. 290-295; 307)

24. The Administrative Law Judge finds as follows:

- a. That XXXXX did in fact fail to report income to the State of Illinois as stated in the Notices of Deficiencies during the years ended December 31, 1980 through December 31, 1987. Also, her Estate failed to protest said deficiencies. Therefore, the deficiency amounts as to XXXXX are deemed assessed.
- b. That XXXXX did not file a joint IL-1040 return with XXXXX for the year ended December 31, 1987. Therefore, no joint and several liability for the subject deficiency due to XXXXX's embezzlement of funds and failure to report additional income to Illinois exists as to XXXXX.
- c. That XXXXX and XXXXX filed a joint IL-1040 return for the year ended December 31, 1987 and properly reported their income. Therefore, the Notice of Deficiency for the year ended 12/31/87 as to XXXXX and XXXXX must be withdrawn.
- d. That XXXXX and XXXXX filed joint IL-1040 returns for the years ended December 31, 1980 through December 31, 1986 and failed to report the additional income which was properly determined by Department audit procedure as stated in the notices of deficiency for said years. Therefore, XXXXX is also liable for the tax due and penalties related thereto except the fraud penalty as stated therein.
- e. That XXXXX had no actual knowledge of the embezzled funds of XXXXX during the years ended December 31, 1980 through December 31, 1987. Therefore, the Section 1002(b) fraud penalties cannot stand as to XXXXX for said years.

DISCUSSION OF LAW AND FACTS: Section 506(b) of the Illinois Income Tax Act provides in pertinent part that:

A Taxpayer must report to the Department not later than 20 days after a final federal change, any recomputation or redetermination of federal income or loss.

Ch. 120, Ill. Rev. Stat. Section 506(b).

Section 502(c)(1) of the Act provides in the case of a joint return by

husband and wife that:

"...if a husband and wife file a joint federal income tax return for the taxable year they shall file a joint return under this Act for such taxable year and their liabilities shall be joint and several..."

Section 502(c)(4) of the Act provides in taxable years ended subsequent to September 22, 1987:

"However, an innocent spouse shall be relieved of liability for tax (including interest and penalties) for any taxable years for which a joint return has been made, upon submission of proof that the Internal Revenue Service has made a determination under Section 6013(e) of the Internal Revenue Code, for the same taxable year, which determination relieved the spouse from liability for federal income taxes."

Ch. 120, Ill. Rev. Stat. Section 502(c)(2), (4).

Section 1002(b) of the Act provides:

Fraud. If any part of a deficiency is due to fraud, there shall be added to the tax as a penalty an amount equal to (50%) 75% of the deficiency. Such amount shall be in lieu of any determined under subsection (a).

Ch. 120, Ill. Rev. Stat. Section 1002(b)

Section 1005(a) of the Act for years ended subsequent to December 31, 1985 provides that:

If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return, a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause. The penalty shall be in addition to any other penalty determined under this Act.

Ch. 120, Ill. Rev. Stat. Section 1005.

In the instant case Taxpayers XXXXX and XXXXX filed joint federal and Illinois 1040 returns for the years ended December 31, 1980 through December 31, 1986. (Tr. 119; Dept. Ex. #20) The record clearly reflected that XXXXX had been guilty of embezzling funds from her employer XXXXX Co. during the years 12/31/80 through 12/31/87. (Dept. Ex. #s 20, 23) The amount of embezzled funds exceeded \$250,000.00 over said period of time. Additionally, XXXXX did not report the embezzled amounts on her yearly

joint returns filed with her husband. (Dept. Ex. #s 23, 25, 26, 17, 20, 23; Tr. 117-119)

XXXXXX was a part-time bookkeeper for XXXXX and worked for a private accountant during the tax seasons in the preparation of income tax returns. XXXXX's income was modest for part-time employment at approximately \$5,000.00 per year. XXXXX, her husband, was a Collection officer/supervisor for the Illinois Department of Revenue during the years in question and worked as a part-time process server until 1985. XXXXX's salary and income was average in the community at approximately \$20,000.00 per year. (Dept. Ex. #23; Tr. 36-72)

The record showed that XXXXX did not learn of XXXXX's embezzlement of funds and additional income until August of 1988. (Tr. 238) XXXXX protested the subject deficiencies based upon the "Innocent Spouse Rule" of IRC Section 6013(d)(3). The IRS, however, did not perform a federal audit or make a federal determination as to the additional income embezzled by XXXXX. (Tr. 177, 213-220)

In prior cases similar to the instant record, the Department relied on the federal determination of an innocent spouse to relieve the innocent party of liability pursuant to Sections 506(b) and 403(b) of the Act (federal change) for the years ended prior to the effective date of Section 502(c) of the Act.

On this record, Section 502(c) of the Act is only applicable to the year ended 12/31/87. However, no federal determination has been made as to XXXXX by the IRS as an innocent spouse, therefore, a literal reading of section 502(c) mandates that the Innocent Spouse Defense cannot relieve XXXXX of liability during the year ended 12/31/87. Additionally, the Innocent Spouse defense is not available to XXXXX for the years ended 12/31/80 through 12/31/86 since Section 502(c) was not adopted during those years and no federal change had occurred. (Tr. 177, 213-220) XXXXX's own

witness, XXXXX, admitted that the failure of the IRS to proceed on Illinois audit information would not preclude Illinois from adjusting or increasing income pursuant to audit information and determination. (Tr. 213, 220).

Notwithstanding the aforementioned, however, the Department was incorrect in apportioning one-half of the unreported income of XXXXX to XXXXX and XXXXX, XXXXX's second wife for the year ended 12/31/87. The record showed that XXXXX and XXXXX filed a joint IL-1040 return for the year ended 12/31/87. Section 502(c)(1) of the Act requires that a joint return be filed by a husband and wife for them to be joint and severally liable for any taxes and penalties due. Clearly, such is not the case on this record. See also, Illinois Letter Rulings No's. IT 87-053, IT 87-299 and IT 88-189. Consequently, the Notice of Deficiency issued against XXXXX and XXXXX for the year ended 12/31/86 must be withdrawn.

The remaining issue to be decided is whether XXXXX is liable for the penalties and tax during the years ended 12/31/80 through 12/31/86. The federal tax case of Ray F. Turner v. Commissioner, 55 TCM 1425, filed July 29, 1988 is a federal case directly on point with the instant record.

In Turner, the husband and wife filed joint tax returns. The husband was a signatory on a joint checking account but he did not actively participate in the family finances. The wife controlled the family finances and kept the account information at her place of employment. The wife was a bookkeeper and embezzled over \$240,000.00 from her employer and subsequently pled guilty to one count of check forgery. Although the wife was able to conceal her criminal conduct from her husband, his ignorance of the embezzlement did not establish that he did not benefit from the fruits of the wife's crimes. The standard of living in the case was much higher in the federal case; however, they lived in a lifestyle in excess of that which could be maintained by their reported income.

The critical point of the case was that the embezzled funds were

deposited into the couple's joint-checking account which the husband has access to by being a signatory on said account as in this case. The Court found that even if he was not actually aware that he was spending embezzled funds, he was benefiting from those funds because they seeped into the family finances and he was spending the funds. The embezzled funds were commingled with their legitimate earnings in their joint checking account and used to purchase all the day to day necessities and other luxuries.

The facts in Turner are practically identical to the instant record. A distinction here, however, is that the XXXXX' standard of living did not appear to increase due to the embezzled funds. The same lifestyle was corroborated by Taxpayers' long social friend and accountant, Mr. XXXXX (Tr. 133-150), and XXXXX's second wife. (Tr. 192-200) A constant, however, was that the embezzled funds were deposited into a joint-checking account with access by either spouse and the funds were commingled with and used for family expenses. Also, the XXXXX lived a lifestyle in a manner that could not be maintained by their own earnings. Their loans, credit card bills and restaurant tabs appeared to be excessive in view of their reported earnings. (Txp. Ex. Group Ex. 9) Additionally, the record contained evidence that showed XXXXX relied on XXXXX's accounting skills to maintain and oversee the family finances and in the preparation of the subject tax returns as in Turner. (Tr. 229-240)

The Turner case applied the four factor test of the so-called "Innocent Spouse Rule" to find that the husband was liable for the underreporting of income since he could not meet all four factors. The rule provides that an innocent spouse is relieved from liability for tax on a joint return if the following four conditions are met:

- a. a joint return has been made under this section for the taxable year;
- b. on such return there is a substantial underpayment of tax attributable to grossly erroneous items of one spouse;

- c. the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such a substantial understatement, and
- d. taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement.

Although the Innocent Spouse Rule does not apply to this record since a federal determination was not made (Tr. 177, 213-220; Dept. Ex. #20), for purposes of analogizing the instant facts to the Turner case the rule must be examined.

The Administrative Law Judge agrees that the first two conditions have been met by XXXXX on this record. The remaining issues as to the last two factors is essentially a factual interpretation, and the test to be applied is what a reasonably prudent person would or should know of the circumstances, keeping in mind the person's level of intelligence, education and experience.

On this record, XXXXX was an intelligent and educated person and well experienced with the Illinois Department of Revenue in the field of collections. Clearly, he was well versed in financial matters and statements of accounts and assets. Notwithstanding the aforementioned, the record showed that he was frequently away from home due to his employment and was oblivious to the status of his family finances. Even so, however, he should have known that the family lived in a lifestyle in excess of their means. A reasonably prudent person would have inquired into the status of over five credit card accounts, lines of credit balances, and savings or checking account balances at least intermittently over a ten-year period. XXXXX testified that he never reviewed checking account statements because they were mailed to a Post Office box and XXXXX would pick them up daily and balance the check book. Also, a reasonably prudent person would examine a tax return before signing it and relate the income reported thereon to his standard of living. (Tr. 270-290).

The Administrative Law Judge believes XXXXX's testimony was questionable as to his lack of knowledge regarding the statement of accounts, assets, liabilities and checking account balances in view of the record showing that no discovery or verification of assets and liabilities was determined by XXXXX or his attorney prior to entering the marital settlement agreement and Dissolution Judgment. (Tr. 275-300) More decisively, the record showed that checking account statements were mailed directly to the XXXXX' residence at XXXXX St., XXXXX, IL 60435; and not to the Post Office Box as testified to by XXXXX. (Txp. Ex. Group Ex. #9; Tr. 229) One finds it hard to believe that review of bank statements and credit card bills to a place of residence was non-existent by a spouse for a period of over ten years. Clearly, XXXXX did not act in a reasonably prudent manner.

Consequently, the third factor has not been met. Additionally, as in Turner, XXXXX benefited from the increase in income. Therefore, XXXXX must be held jointly and severally liable for the tax due regarding the unreported income during the years ended 12/31/80 through 12/31/86. Furthermore, based upon the best information available to the Department, Auditor, Lance Evans, properly determined and computed the subject taxes due and penalties. Finally, the Section 1005 penalty is justified for the same reasons because reasonable cause does not exist on this record to abate the penalty.

The Section 1002(b) fraud penalties, however, must also be addressed on this record. To establish fraud, the Department must show that Taxpayer intended to evade taxes known or believed to be owing by conduct calculated to conceal, mislead, or otherwise prevent the collection of such taxes. Rowlee v. Commissioner, 80 T.C. 1111 (1980). A pattern of consistent underreporting of income for a number of years justifies the inference of fraud as to each year. Holland v. United States, 348, U.S. 121 129 (1954).

However, the Department must prove the Taxpayer committed fraud; it is not sufficient that Taxpayer's wife committed fraud. Section 6653(b) of the IRC, *Stone v. Commissioner*, 56 T.C. 213 (1971). The rule is clearly explained in pertinent federal regulations that state "No person filing a joint return shall be held liable for a fraud penalty except for his own personal fraudulent conduct." Consequently, the fraudulent conduct of XXXXX cannot be transferred to XXXXX.

On this record, as in the Turner case, XXXXX did not commit fraud because he was not aware of XXXXX's embezzlement until she was arrested in August of 1988. (Tr. 272-304) XXXXX was not involved in the financial aspects of the marriage subsequent to 1975. XXXXX had control of the check book and accounts payable records. XXXXX was unaware that embezzled funds were being deposited into the checking account although he could have inspected the account. It is irrelevant that he did not. (Tr. 290-307) The record did not contain any evidence that XXXXX had told him she was embezzling money from her employer, nor was there any evidence that anyone else told him.

Although much of XXXXX's testimony was self serving and some was not credible, the facts on this record remain that XXXXX did not have actual knowledge of the embezzled funds. The law does not transfer the fraud of a spouse to the imprudent or negligent spouse as to a fraud penalty. The Department did not prove on this record any scienter or deceit on XXXXX XXXXX behalf, therefore, fraudulent intent cannot be proved. Consequently, the Section 1002(b) penalties as to XXXXX must be abated for the years ended 12/31/80 through 12/31/86.

DECISION: It is the Director of Revenue, that decision of:

- a. XXXXX is liable for the Notice of Deficiency amounts of tax and penalties for the years ended 12/31/80 - 12/31/87 due to her failure to report additional income derived from her embezzlement conduct and failure to protest the subject deficiencies:

COMPUTATIONS:

Y/E 12/31/80

As Corrected

ADJUSTED GROSS INCOME	\$58,173.00
BASE INCOME	58,173.00
Exemption(s)	4,000.00
NET INCOME	54,173.00
INCOME TAX @ 0.025%	1,354.00
Tax Previously Assessed	422.00
Additional Tax Liability	932.00
Section 1002(b) Penalty @ 0.5%	466.00
STATUTORY DEFICIENCY	\$ 1,398.00

Y/E 12/31/81

As Corrected

ADJUSTED GROSS INCOME	\$60,109.00
ADDITIONS:	
Other	
SUBTRACTIONS:	47.00
Illinois Tax Refund	58.00
BASE INCOME	60,098.00
Exemption(s)	4,000.00
NET INCOME	56,098.00
INCOME TAX @ 0.025%	1,402.00
Tax Previously Assessed	470.00
Additional Tax Liability	932.00
Section 1002(b) Penalty @ 0.5%	466.00
STATUTORY DEFICIENCY	\$ 1,399.00

Y/E 12/31/82

As Corrected

ADJUSTED GROSS INCOME	\$60,848.00
ADDITIONS:	
Other	13.00
BASE INCOME	60,861.00
Exemption(s)	4,000.00
NET INCOME	56,861.00
INCOME TAX @ 0.025%	1,422.00
Tax Previously Assessed	489.00
Additional Tax Liability	933.00
Section 1002(b) Penalty @ 0.5%	466.00
STATUTORY DEFICIENCY	\$ 1,399.00

Y/E 12/31/83

As Corrected

ADJUSTED GROSS INCOME	\$62,478.00
BASE INCOME	62,478.00
Exemption(s)	4,000.00
NET INCOME	58,478.00
INCOME TAX @ 0.03%	1,754.00
Tax Previously Assessed	636.00
Additional Tax Liability	1,118.00
Section 1002(b) Penalty @ 0.5%	559.00
STATUTORY DEFICIENCY	\$ 1,677.00

Y/E 12/31/84

As Corrected

ADJUSTED GROSS INCOME	\$57,267.00
BASE INCOME	57,267.00
Exemption(s)	4,000.00
NET INCOME	53,267.00
INCOME TAX @ 0.0275%	1,465.00
Tax Previously Assessed	571.00
Additional Tax Liability	894.00
Section 1002(b) Penalty @ 0.75%	671.00
STATUTORY DEFICIENCY	\$ 1,565.00

Y/E 12/31/85

As Corrected

ADJUSTED GROSS INCOME	\$67,996.00
SUBTRACTIONS:	
Illinois Tax Refund	71.00
BASE INCOME	67,925.00
Exemption(s)	4,000.00
NET INCOME	63,925.00
INCOME TAX @ 0.025%	1,598.00
Tax Previously Assessed	577.00
Additional Tax Liability	1,021.00
Section 1002(b) Penalty @ 0.75%	766.00
STATUTORY DEFICIENCY	\$ 1,787.00

Y/E 12/31/86

As Corrected

ADJUSTED GROSS INCOME	\$75,227.00
SUBTRACTIONS:	
U.S. Government Interest	21.00
BASE INCOME	75,206.00
Exemption(s)	4,000.00
NET INCOME	71,206.00
INCOME TAX @ 0.025%	1,780.00
Tax Previously Assessed	628.00

Additional Tax Liability	1,152.00
Section 1002(b) Penalty @ 0.75%	864.00
Section 1005 Penalty	193.00
STATUTORY DEFICIENCY	\$ 2,209.00

Y/E 12/31/87

As Corrected

ADJUSTED GROSS INCOME	\$24,915.00
BASE INCOME	24,915.00
Exemption(s)	2,000.00
NET INCOME	22,915.00
INCOME TAX @ 0.025%	573.00
Tax Previously Assessed	67.00
Additional Tax Liability	506.00
Section 1002(b) Penalty @ 0.75%	379.00
Section 1005 Penalty @ 6% Per Annum	54.00
STATUTORY DEFICIENCY	\$ 939.00

- b. That XXXXX and XXXXX filed a joint IL-1040 return for the year ended 12/31/87, therefore, no joint and several liability for the deficiency due to XXXXX's embezzlement of funds and failure to report additional income to Illinois exists to XXXXX. Consequently, the Notice of Deficiency as to XXXXX and XXXXX must be withdrawn for the year ended 12/31/87.
- c. That XXXXX and XXXXX filed joint IL-1040 returns for the years ended December 31, 1980 through December 31, 1986 and failed to report the additional income as stated in the Notices of Deficiency, therefore, XXXXX is joint and severally liable for the taxes due in said years and 1005 penalty for the year ended 12/31/86. Additionally, however, the Department failed to prove that XXXXX had actual knowledge of the embezzled funds by XXXXX, therefore, the Section 1002(b) fraud penalties must be abated. Consequently, XXXXX is liable for the following tax and penalties:

COMPUTATIONS:

Y/E 12/31/80

As Corrected

ADJUSTED GROSS INCOME	\$58,173.00
BASE INCOME	58,173.00
Exemption(s)	4,000.00
NET INCOME	54,173.00
INCOME TAX @ 0.025%	1,354.00
Tax Previously Assessed	422.00
Additional Tax Liability	932.00
Section 1002(b) Penalty @ 0.5%	0.00
STATUTORY DEFICIENCY	\$ 932.00

Y/E 12/31/81

As Corrected

ADJUSTED GROSS INCOME	\$60,109.00
ADDITIONS:	
Other	
SUBTRACTIONS:	47.00
Illinois Tax Refund	58.00
BASE INCOME	60,098.00
Exemption(s)	4,000.00
NET INCOME	56,098.00
INCOME TAX @ 0.025%	1,402.00
Tax Previously Assessed	470.00
Additional Tax Liability	932.00
Section 1002(b) Penalty @ 0.5%	0.00
STATUTORY DEFICIENCY	\$ 933.00

Y/E 12/31/82

As Corrected

ADJUSTED GROSS INCOME	\$60,848.00
ADDITIONS:	
Other	13.00
BASE INCOME	60,861.00
Exemption(s)	4,000.00
NET INCOME	56,861.00
INCOME TAX @ 0.025%	1,422.00
Tax Previously Assessed	489.00
Additional Tax Liability	933.00
Section 1002(b) Penalty @ 0.5%	0.00
STATUTORY DEFICIENCY	\$ 933.00

Y/E 12/31/83

As Corrected

ADJUSTED GROSS INCOME	\$62,478.00
BASE INCOME	62,478.00
Exemption(s)	4,000.00
NET INCOME	58,478.00
INCOME TAX @ 0.03%	1,754.00
Tax Previously Assessed	636.00
Additional Tax Liability	1,118.00
Section 1002(b) Penalty @ 0.5%	0.00
STATUTORY DEFICIENCY	\$ 1,118.00

Y/E 12/31/84

As Corrected

ADJUSTED GROSS INCOME	\$57,267.00
BASE INCOME	57,267.00
Exemption(s)	4,000.00
NET INCOME	53,267.00
INCOME TAX @ 0.0275%	1,465.00
Tax Previously Assessed	571.00
Additional Tax Liability	894.00
Section 1002(b) Penalty @ 0.75%	0.00
STATUTORY DEFICIENCY	\$ 894.00

Y/E 12/31/85

As Corrected

ADJUSTED GROSS INCOME	\$67,996.00
SUBTRACTIONS:	
Illinois Tax Refund	71.00
BASE INCOME	67,925.00
Exemption(s)	4,000.00
NET INCOME	63,925.00
INCOME TAX @ 0.025%	1,598.00
Tax Previously Assessed	577.00
Additional Tax Liability	1,021.00
Section 1002(b) Penalty @ 0.75%	0.00
STATUTORY DEFICIENCY	\$ 1,021.00

Y/E 12/31/86

As Corrected

ADJUSTED GROSS INCOME	\$75,227.00
SUBTRACTIONS:	
U.S. Government Interest	21.00
BASE INCOME	75,206.00
Exemption(s)	4,000.00
NET INCOME	71,206.00
INCOME TAX @ 0.025%	1,780.00
Tax Previously Assessed	628.00
Additional Tax Liability	1,152.00
Section 1002(b) Penalty @ 0.75%	0.00
Section 1005 Penalty	193.00
STATUTORY DEFICIENCY	\$ 1,345.00

James Pieczonka
Administrative Law Judge

Date